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SUBJECT: CODEL PRICE SCENESETTER

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SUMMARY  
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**¶1.** (SBU) Embassy Asuncion warmly welcomes Codel Price August 19-20. Your visit will come on the heels of President Fernando Lugo's one-year anniversary in office, and will find the Lugo government grappling with the challenges of day-to-day governing. An inexperienced team, exceedingly high expectations for change, endemic corruption, weak institutions, and a divided Congress make Lugo's job more difficult. Lugo needs to generate jobs and promote economic development while downsizing a bloated state and tackling social and security issues of key concern to his constituents. His top goals are fighting corruption, strengthening weak institutions, and promoting economic growth. Your visit offers the United States an opportunity to reaffirm support for Paraguay's democratic institutions, and in particular, its politically beleaguered and divided Congress. END SUMMARY.

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LOCAL AND REGIONAL POLITICS  
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**¶12.** (SBU) Fernando Lugo's administration represents the first interruption in Colorado Party rule in 61 years. By voting overwhelmingly for change, the Paraguayan people gave former Catholic bishop Lugo a mandate for political, economic, and social reform. However, they also have high expectations. Lugo took office on August 15, 2008 -- with his one-year anniversary coming just before your visit. He appears to be committed to reform, but is discovering that real change is difficult to bring about.

**¶13.** (SBU) Lugo is a leftist at heart, but a pragmatist of mind. He maintains close relations with Venezuela, Bolivia, and Ecuador, but also with the United States, Chile, Brazil, Colombia and others. He said in late July that Paraguay's "first circle" is MERCOSUR, and that Paraguay does not seek to join the Bolivarian revolution. Lugo visited Washington for the first time in May 2007, and traveled to New York for the United National General Assembly (UNGA) last fall. Lugo met with President Bush in Washington in October 2008; he saw President Obama at the Summit of the Americas in Trinidad and Tobago, as well as a congressional delegation led by Congressman Engel.

**¶14.** (SBU) Lugo's challenges are many: His inexperienced team needs to meet Paraguayans' high expectations for change, but will have to overcome endemic corruption, weak institutions, and a divided Congress to do so. Lugo's Patriotic Alliance

for Change (APC), a loose coalition of political parties, won a large block of seats in Congress but does not have a majority. Lugo's own Christian Democrat party is not represented in Congress. The Liberal Party, one of Paraguay's major political parties, waffles back-and-forth in its support for Lugo, and Lugo has distant (at best) relations with his Liberal Party Vice President, Federico Franco.

Lugo's own inner circle continues to jockey for power and ideological influence. Executive-congressional relations have also been somewhat bumpy. Social organizations and leftist political parties have repeatedly criticized Congress for blocking reforms, and threaten to block highways into Asuncion and to surround Congress on August 10 in an effort to pressure Congress to deliver agrarian and judicial reform.

So far, Lugo has weathered the storms he has faced (including several paternity scandals), but he has yet to develop a clear national agenda, or to engage in the daily political brokering which will be critical to his administration's success.

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#### THE ECONOMIC REALITY

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**¶5.** (SBU) Although Paraguay's macroeconomic indicators show the country is reasonably positioned to face the financial crisis, the economy is expected to contract at least three percent this year, and will continue to shed jobs in the process. Paraguay's Central Bank revised its projection to a 1.0 percent growth rate for 2009 (compared to 5.8 percent in 2008). Exports markedly slowed in the first half of 2009 as result of lower prices and weaker external demand for Paraguay's main export commodities (soy, grains, cattle). Paraguay is projecting a fiscal deficit of less than one percent of GDP in 2009, and a trade deficit of 1.5 percent of GDP (2008 GDP was USD 16 billion). Unemployment is over 20 percent, and with a population growth rate above 2 percent per annum, the economy is not creating enough jobs to meet demand. In spite of a large and growing labor force, experts cite the lack of skilled workers as an obstacle to economic growth. Paraguay boasts vast hydroelectric resources, including the massive Itaipu hydroelectric dam built and operated jointly with Brazil, but fails to capitalize on those resources. The new government purports to welcome foreign investment, but widespread corruption and a weak judicial system are deterrents. In addition to retail, banking, and professional services, there is significant commercial activity involving the import of goods from Asia and to a lesser extent the United States for re-export to neighboring countries, mainly Brazil. The underground economy, which is not included in the national accounts, probably equals the formal economy in size.

**¶6.** (SBU) Paraguay's relative isolation from international capital markets reduced the impact of the financial crisis on the local banking system. However, as an agriculture commodity exporter, the impact of lower demand is felt across all productive sectors. Agriculture, which represents about 25 percent of GDP, is expected to decline over 20 percent in 2009. More than 250,000 families depend on subsistence farming activities and maintain marginal ties to the larger productive sector of the economy. The executive branch is lobbying Congress for approval of a USD 100 million loan from the World Bank, which is a key component of Paraguay's response to the financial crisis, but has been stalled for months in Congress. Lugo is under pressure to reduce poverty and create jobs, but the government's capacity to deliver on those promises is limited.

**¶7.** (SBU) Bilateral trade with the United States has increased over the last six years. The U.S. imported from Paraguay about USD 80 million in 2008, and exported over USD 1.6 billion, up from USD 1.2 million in 2007. Paraguay withdrew its objection to U.S. trade preferences in the WTO last March, thus opening the door for future trade discussions. More than a dozen U.S. multinational firms have subsidiaries in Paraguay, and some 75 U.S. businesses have agents or representatives in Paraguay. Cargill, ADM, Coca Cola, and

Exxon Mobile are the largest U.S. companies operating in Paraguay. With over USD 650 million in private investment stock, the U.S. is Paraguay's largest investor.

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PUBLIC SECURITY AND SOCIAL ISSUES  
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¶ 8. (SBU) Security and social issues are top concerns of Lugo's constituents. Violent crime is increasing in urban and rural areas, and the public generally believes that Paraguayan security forces (particularly the corrupt police) do not meet their security needs. The "landless" farmer movement -- active for many years in Paraguay -- has organized protests and land invasions, calling for reform by illegally occupying large, privately-held ranches. On some occasions, protests and land invasions have resulted in deaths or injuries.

¶ 9. (SBU) The Tri-Border Area (TBA) of Paraguay, Argentina and Brazil is a hub for transnational criminal activity including drug trafficking, trafficking in persons (TIP), arms trafficking, intellectual piracy, and money laundering. Paraguay is a major transshipment point for cocaine from Colombia and Bolivia to Brazil; it is the top marijuana producer in South America and the second largest in the world. Paraguay remains a regional haven for money laundering. Paraguayan authorities often experience difficulties enforcing the law because of hostile geography, corruption, chronic understaffing, and the political and judicial power some drug traffickers wield. Paraguay took a giant step forward on money laundering, intellectual property violations, and trafficking in persons by passing a tougher penal code that went into effect in July.

¶ 10. (SBU) Inefficient, state-run institutions dominate Paraguayan social services, and Lugo pledged to make health care and education reform government priorities. Social services spending increased since 2003; however, most spending augmented employees' salaries. Many Paraguayans lack basic access to health care facilities, particularly in rural areas, and many more are uninsured. Influenza H1N1 is testing Paraguay's capacity to respond to a pandemic, and intensive care hospital beds have been 100 percent occupied for several weeks now. Government agencies and state-owned enterprises provide basic public services, but access is limited and services have deteriorated in quality.

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LUGO'S GOALS AND U.S. ASSISTANCE TO PARAGUAY  
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¶ 11. (U) Lugo's goals are to strengthen democratic institutions, fight corruption, and promote economic growth. Reforming the National Police and land reform, including a national land survey, are also priorities. He promised to promote a "social justice" agenda. Judicial reform remains on Lugo's agenda, and after a few starts and stops, it appears that the Senate may soon vote on a two-year-long Supreme Court vacancy.

¶ 12. (U) U.S. assistance in Paraguay supports many of Lugo's goals. The centerpiece of our assistance is Phase Two of the Millennium Challenge Corporation's Threshold Program, which the Paraguayan Congress approved July 31. The Threshold Program, worth USD 30 million, focuses on anti-corruption. Paraguay's new Congress, despite its predecessor's fairly poor performance under Phase I of the Threshold Program, was eager to play a watch-dog role under Phase II. USAID/Paraguay's FY09 budget is USD 17.15 million and focuses on Economic Growth; Health Care; Sustainable Management of Natural Resources and Protected Areas; and Democratic Strengthening. USAID's Economic Growth Program ("Paraguay Vende") has generated over USD 60 million in additional sales and over 30,000 full-time job equivalents since 2003, thus supporting Lugo's goal to reduce poverty. Likewise, USAID's Health Program supports Lugo's stated interest in improving basic health services. Specifically, it targets

decentralizing health services, improving maternal and child care services, and increasing Paraguay's capacity to deliver family planning services. In the environment sector, USAID continues to support improved management of protected areas. The Democracy Program focuses on fighting corruption, giving civil society a voice, and promoting decentralization and municipal development.

**¶13. (U)** The Embassy's leading public diplomacy effort is its English language scholarship program, which identifies academically outstanding young Paraguayans from families with limited resources. Since the program's inception in 2006, the Embassy has awarded close to 700 scholarships plus 100 scholarships for public school teachers. USG support for the Paraguay Military Forces is second only to our support for Colombia in South America. One highlight is the U.S. Armed Forces' USD 4.1 million donation of Global Peace Operations Initiative (GPOI) funds and technical assistance to Paraguay's United Nations Global Peace Keeping Operations Program (UNPKO). Other security funding includes State's International Narcotics and Law Enforcement (INL) money, which along with DEA and U.S. Special Forces, assists Paraguay's Anti-Drug Secretariat (SENAD) and other institutions in combating narcotics trafficking, money laundering, IPR violations, and trafficking in persons.

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COMMENT  
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**¶14. (SBU)** Your visit offers the United States an opportunity to reaffirm support for Paraguay's democratic institutions, and in particular, its politically beleaguered and divided Congress. Lugo has stated that he seeks to strengthen democratic institutions; Congress' poor public image due to corruption and political divisions make it a good candidate for U.S. congressional assistance at a critical time in Paraguay's democratic transition. END COMMENT.  
Holloway